NOTES

WASHINGTON NOTES

THE SUPPLEMENTARY INCOME TAX DECISIONS

The Supreme Court of the United States handed down on February 21 important decisions supplementary to the general opinion on the income tax, already outlined in a former number of this *Journal*. These are the opinions in *Dodge* v. *Osborn* (No. 396, October Term, 1915), *Dodge* v. *Brady* (No. 213, *ibid.*), *Tyes Realty Co.* v. *Anderson* (Nos. 393 and 394), and *Stanton* v. *Baltic Mining Co.* (No. 359). The opinions in question pass, in more detail than the general decision, upon two important aspects of the income tax, viz.: (1) the constitutionality of the "surtax" or excess tax on the higher incomes, and (2) the question whether income derived in part from, or accompanied by and based upon, the physical deterioration of property is taxable exactly as if it were the result of current operations solely.

In the three cases first enumerated, various aspects of the constitutionality of the surtax are dealt with. Practically every contention relied upon in them for the defeat of the constitutionality of the income tax is embraced in the following propositions: (*a*) that the tax imposed by the statute was not sanctioned by the Sixteenth Amendment, because the statute exceeded the exceptional and limited power of direct income taxation for the first time conferred upon Congress by that amendment, and, being outside of the Amendment, and governed solely therefore by the general taxing authority conferred upon Congress by the Constitution, the tax was void as an attempt to levy a direct tax without apportionment under the rule established by *Pollock* v. *Farmers' Loan and Trust Co.;* and (*b*) that the statute is, moreover, repugnant to the Constitution, both because of the provision therein contained for its retroactive operation for a designated time, and because of the illegal discriminations and inequalities which it creates, including the provision for a progressive tax on the income of individuals and the method provided in the statute for computing the taxable income of corporations. These two contentions were largely discussed in the original income-tax decision, but the positions therein taken are now reiterated and specifically applied to the surtax imposed upon progressive principles.

As the particular circumstances and conditions under which the payment of the "surtax" has been protested differ in the three cases, and as in each the general finding of the income-tax decision is applied without modification, the series of opinions amounts to a broad general vindication and reassertion of the constitutionality of the surtax provision of the income tax, under practically all probable conditions.

In the Baltic Mining case, the complainants attacked the constitutionality of the income tax on the ground that the "income" of mining companies really consisted in part of capital depreciation and that to tax this was unjust for the following reasons:

1. Because all other tax contributors were given a right to deduct a fair and reasonable percentage for losses and depreciation of their capital, and they were therefore not confined to the arbitrary 5 per cent fixed as the basis for deductions by mining corporations.

2. Because by reason of the differences in the allowances which the statute permitted, the tax levied was virtually a net income tax on other corporations and individuals and a gross income tax on mining corporations.

3. Because the statute established a discriminating rule as to individuals and other corporations as against mining corporations in the method of the allowance for depreciation.

4. Because of the discrimination created by permitting individuals to deduct dividends received from corporations, by permitting the exemption of individual incomes below $4,000, and through other methods of exemption and supposed favoritism.

The Court promptly disposes of the allegations of favoritism based on mode of assessment as having been settled by the reasoning offered in the general income-tax decision; and, in dealing with the supposed peculiarity of mining property which results in its depletion as the ore is taken out, it reduces the question at issue to a special phase of the problem: What is income? As to this, the decision takes the position that there is no good ground for the view that—

the peculiarity of mining property and the exhaustion of the ore body which must result from working the mine causes the tax in a case like this where an inadequate allowance by way of deduction is made for the exhaustion of the ore body to be in the nature of things a tax on property, because of its ownership, and therefore subject to apportionment.

Further analysis of this contention leads to its dismissal with the remark that there is no ground for the view that a tax on the product of a mine is necessarily a direct tax on property, but that, on the contrary, such a view is "wholly fallacious." The constitutionality of income

taxes which are levied upon returns obtained partly through the exhaustion of the physical basis of the property from which income is drawn is accordingly sustained.

A NEW TARIFF COMMISSION PLAN

President Wilson's act in recommending the appointment of a tariff commission, and the introduction of a bill for the establishment of such a board (H.R. 10585, 64th Cong., 1st sess.), has brought the tariff discussion to a new stage of development. The action is of unusual interest because, as is plainly stated by the President in his letter of January 26, the recommendation represents a distinct change of position on his part, as well as a breach with the past policy of the Democratic party. It will be recalled that the so-called Tariff Board, which was established by ex-President Taft under a general or blanket authority bestowed by Congress in an appropriation made in connection with the Payne-Aldrich Tariff act, was disestablished by the Democrats in consequence of their view that a tariff commission was not needed in determining the rates of import duties. The contest developed into a sharp struggle between the regular and Progressive Republicans and the Democrats in both branches of Congress, and ultimately resulted in the entire abandonment of the project. The element in the establishment of the Tariff Board to which critics of the organization took most exception was the provision that it should investigate comparative cost of production in the United States and foreign countries, with a view to recommending changes in tariff duties based upon differences in such cost. Experience shows that the differences in cost of production were greater, as between more efficient and less efficient plants located in the United States, than between American plants, either as individuals or on the average, and foreign establishments. As much of the work of the Tariff Board was based upon this theory of making rates vary in accordance with differences in cost, it was the opinion of some critics that the Board's work was not valuable. Nevertheless, the Board, during its existence, succeeded in accumulating a very considerable mass of data and statistics relating to various industries. The new commission to be established under the bill already referred to is expected to have very large powers, including investigation of rates of duties, the status of commercial credit, "and all conditions, causes, and effects relating to unfair competition of foreign industries with those of the United States, including dumping." The Cost of Production Division in the Bureau of Foreign and Domestic Commerce, as well as all records, papers, etc., formerly belonging to the Tariff Board, are to be transferred to the new commission. The com-

mission is authorized to summon witnesses and administer oaths, so that its powers are practically as broad as any that have been asked by the more reasonable advocates of tariff commission within recent years. Nowhere, however, is there a suggestion that the new commission is to devote itself primarily to the investigation of differences in cost of production; and nowhere is there any instruction to it to recommend rates of duty to be enacted by Congress. The commission is to "submit from time to time to Congress the reports of its investigations" in regard to the working of the tariff, but the evident intent of the measure is that these reports shall be of a semiscientific and non-political nature.

This tariff commission enterprise is, therefore, obviously different in its nature both from the former Tariff Board and from other tariff commission plans that have been put forward from time to time in recent years. However, the adoption of any tariff commission idea by the Democratic party within two years of the time when the general concept of such a commission had been rejected by accredited representatives of that party, constitutes a striking example of the rapidity with which political issues and conditions are now changing.

EARNINGS OF FEDERAL RESERVE BANKS

The Federal Reserve Board has issued a complete tabular and analyzed statement showing the cost and character of the business done by the reserve banks during the past year. From this statement it is shown that the aggregate earnings for the year 1915 were $2,130,610.00, while the aggregate expenses were $1,490,729.00, leaving a net income of about $640,000.00. The final result of the year's operations shows that two of the banks have paid dividends (Richmond at 5 per cent and Dallas at 3 per cent), while one other is in position to pay a dividend. Dividends, under recent regulations of the Board, are not payable until after both organization and current expenses have been written off. The payment of a dividend by a bank, therefore, means that it has provided for cost of its federal reserve notes, its furniture and fixtures, and all introductory outlays, in addition, of course, to its current or going charges. Several of the banks have covered current and organization expenses with a small or negligible margin, and two show a deficit for the current operations of the year. The experience, although covering a full year's operation in the technical sense, is not regarded as representative, for the reason that during the first half-year the regulations governing the business of the banks had not been fully developed, the general situation as to commercial paper was even less well-defined than at present, while throughout there has been a condition of ease of money

that has precluded the member banks, as well as the federal reserve banks, from earning as they otherwise would have been able to. On the whole, therefore, the showing of the banks during their first year of experience is considered satisfactory.

The analyses of the business done by the federal reserve banks are equally interesting, as they show that about 75 per cent of the business at the close of the year was being obtained from so-called open-market operations, including municipal warrants, government bonds, and bankers' acceptances, with a very small amount of commercial paper. Of the relatively small percentage of the total business which consisted of rediscounts for member banks, practically all was transacted on behalf of the smaller or country institutions, very few city banks making application owing to the great plethora of available funds. In the rediscounted paper the smaller denominations figure to a preponderating degree, items not to exceed $5,000 constituting fully 50 per cent of the total business. Another striking feature of the operations of the banks is that so little of their real work has been done through the issue of currency. Only about $17,000,000 of notes protected by commercial paper were outstanding at the close of the year, all other notes being substantially gold certificates. The bulk of the accommodation extended by the banks during the past year has unmistakably been effected either through credits on their own books, or else through the actual payment of reserve money out of the vaults. One reason for this latter situation is the fact that the undeveloped state of the clearance and collection system has prevented banks from carrying excess balances with the reserve institutions to the extent that may normally be expected in the near future.

AN INVESTIGATION OF PIPE-LINES

The Federal Trade Commission has rendered a report on the pipe-line transportation of petroleum which adds a considerable amount of material to the data already available on that subject. This report has the additional interest of being one of the first to be issued by the commission in question.

The report deals with the transportation of crude oil by the five large interstate pipe-line systems tapping the mid-continent field, which includes the oil-producing pools of Kansas, Oklahoma, northern Texas, and northern Louisiana. It was made in response to a resolution of the Senate (S. Res. No. 109, 63d Cong., 1st sess.), but deals with only a part of the subject indicated by this resolution, the investigation of other

matters not having been completed. This report is also responsive, in part, to another resolution of the Senate (S. Res. No. 457, 63d Cong., 2d sess.). Subsequent to the passage of the first of these resolutions the Senate directed an inquiry to be made by the Interstate Commerce Commission, which involved the subject of pipe-line transportation. The Federal Trade Commission investigation was practically completed before the Senate directed the Interstate Commerce Commission to make its inquiry. In order to avoid as far as possible any duplication of work, a mutual arrangement was made by the two commissions, whereby the Federal Trade Commission completed its investigation of the large interstate pipe-line systems operating in the mid-continent field and the Interstate Commerce Commission began an investigation of the pipe-line systems operating east of the Mississippi River. These large eastern pipe-line systems were therefore not covered by the investigation of the Federal Trade Commission and are not considered in this report.

This report shows the total investment of the companies which operate these five large interstate systems, their total earnings, their investment in pipe-lines, the cost of transporting crude oil by pipe-lines, the charges and regulations imposed by them for the carrying of oil for other shippers, the excess of such charges over the actual cost of transporting crude oil through pipe-lines, the earnings which would be realized by the pipe-line companies if such charges were paid on all oil shipped by them, and other phases of the present conditions of pipe-line transportation.

The general conclusion arrived at is that the earnings of the companies owning pipe-lines average a little less than 20 per cent, and that lower rates would be necessary in many cases to enable the small refineries not owning pipe-lines to compete with the large companies which do own the lines. In closing, the Commission says:

> The conclusion is evident that lower rates and equitable shipping requirements by pipe-line are necessary in order to make pipe-lines common carriers in fact as well as in law, and that the prosperity and perhaps even the existence of many small concerns are dependent upon reasonable and equitable shipping conditions.
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> Lower pipe-line rates and reasonable pipe-line shipping requirements would enable many small producers and refiners to transport crude oil from the mid-continent field by pipe-line who are now unable to do so, and would, therefore, tend to equalize competition in the sale of crude oil by increasing it in some markets where it is slight or non-existent and by reducing it in others where it is extraordinarily keen. While the natural disadvantage of location of the mid-continent field with respect to the largest consuming markets cannot be

removed, the artificial disadvantage due to high pipe-line rates and shipping requirements can be eliminated.

REFUNDING THE NATIONAL DEBT

A definite beginning has been made in refunding the outstanding bonded debt of the United States, available for use as security for circulation, into higher interest-bearing bonds without the circulation privilege. The Federal Reserve Act provides for the sale of $25,000,000 annually of bonds held by national banks to federal reserve banks, such bonds to be duly allotted to them by the Federal Reserve Board on the basis of applications for sale filed with the Treasurer of the United States. In addition, the act contains provisions understood to authorize the Secretary of the Treasury to convert not only these $25,000,000 of bonds to be taken over by federal reserve banks from their members, but also such other bonds as they might buy in the open market, into 3 per cent securities, either thirty-year bonds, or one-year gold notes. Both phases of this bond operation have now been definitely arranged, and after April 1 the first allotment will be made, upon a quarterly basis aggregating $25,000,000 annually, to the federal reserve banks. The Secretary of the Treasury has undertaken, according to a letter of February 28, addressed to the Board, to convert $30,000,000 of 2 per cent securities into 3 per cent bonds or notes during the current year. In this letter Mr. McAdoo says:

> I am now prepared to issue upon application and approval, as aforesaid, thirty-year 3 per centum gold bonds and one-year gold notes in exchange for United States 2 per centum gold bonds bearing the circulation privilege, but against which no circulation is outstanding, of the face value of $30,000,000 during the year 1916 upon the making of satisfactory obligations by the federal reserve banks in case of the issuance to them of one-year gold notes. Until further ordered I will issue such proportion of one-year gold notes, not exceeding one-half in amount of the bonds offered for conversion, as the banks may apply for, provided that in each instance the proportion applied for by the banks is approved by the Federal Reserve Board.
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> Such conversions will be made quarterly on the first days of January, April, July, and October, which dates correspond to the interest periods for the 2 per cent consols of 1930, and applications must have been received prior to such in order to have the exchanges made. The bonds and notes are now in the hands of the Bureau of Engraving and Printing, and in the event they are not ready for delivery when conversions are effected, temporary forms of bonds and notes will be issued which may later be exchanged for the permanent securities.

By a subsequent letter dated March 4, however, the Secretary of the Treasury has fixed the relative proportion of the bonds and notes to be issued by him in the conversion operation at 50 per cent each, so that a reserve bank applying for the conversion of 2 per cent bonds would be obliged to take one-half of its new securities in bonds and the other half in one-year notes. Inasmuch as the federal reserve banks are holders of approximately $30,000,000 in bonds, the arrangements now made are sufficient to enable them to convert all of their securities into 3 per cent issues. In the past the Federal Reserve Board has held that bonds bought in the open market by federal reserve banks may, if they desire, be offset against such bonds as may be allotted to them as their proportion or share of the $25,000,000 purchase. It cannot therefore be stated exactly to what extent federal reserve banks will actually be compelled to take over allotments of bonds as part of the $25,000,000 operation, since it is as yet uncertain how far they will wish to make use of this privilege of offset. Should they not employ the offset at all, they would, at the end of the year 1916, be holders of $25,000,000 in bonds which they had not been able in the meantime to convert.

The important aspect of the situation does not lie in the relatively small amount of bonds whose conversion is now undertaken, but in the fact that discussion during the past few months has resulted in recognizing the power of the Secretary of the Treasury to convert as many of these bonds as he may see fit into 3 per cent securities, so that both he and his successors will be able to regulate the rate of conversion in accordance with the capacity of the Treasury to make provision for the cost, of such changes. Thus is definitely set on foot the policy of retiring the bond-secured circulation which has so long been justly regarded as a principal source of difficulty and weakness in the currency system of the United States, inasmuch as the existence of the bonds with circulation privilege has provided a temptation for the issue of unnecessary national bank currency, and, incidentally, an obstacle to the retirement of such currency when it was no longer needed. In almost all of the currency plans of the past, provision for these bonds was regarded as essential to the attainment of an elastic currency, and experience under the Federal Reserve act has made it plain that actual progress depends in a great degree upon the withdrawal of the existing bonds with circulation privileges. This amounts to saying that a beginning has at length definitely been made in developing one of the cardinal elements in true currency reform, and that a means has been found for expediting progress in that direction at as rapid a rate as the capacity of the Treasury will permit.